18.03 Statement of Cash Flows - Indirect Method

Indirect Method (Reconciliation Approach)

When applying the indirect method, begin with **Net Income** and make 3 types of adjustments.

1. **Noncash items are adjusted** (Depreciation and Amortization expense is added back, equity in earnings is deducted)
2. **Nonoperating items** are adjusted (deduct the gain from sale of an Available-for-sale security, since this is an Investing activity)
3. Changes in the balances of **accrual related accounts are adjusted** (A/R, Inventory, A/P, Allowance for credit losses (A/R), Amortization of Discount, and taxes)

Operating activities (indirect method)	**Dr.**	**Cr.**	**Change**
Net income	**$140**		
Depreciation expense	50		
Equity in earnings		$10	
Gain on sale of AFS investment		10	
Increase in A/R		80	
Increase in Inventory		30	
Increase in A/P	20		
Increase in Credit losses (allowance)	20		
Amortization of Discount	5		
Decrease in Deferred tax liability		10	
Increase in tax payable	40		
Net cash ***provided*** by operating activities	$275	$140	**$135**

Indirect method:

Begin with **Net Income of $140.** The following adjustments are then made:

1. **Noncash items are adjusted.** Since Depreciation and Amortization expense did not result in the use of any cash but was deducted from Net Income, the depreciation expense is added back to Net income ($50). Income from the investment held under the Equity method was also received, but it did not result in the inflow of any cash. Since the income recorded as "equity in earnings" was included as income, but did not result in the inflow of any cash, the income is deducted from Net income ($10). (Note: under the direct method, these were ignored)
2. **Nonoperating items are adjusted.** The sale of the AFS investment resulted in a $10 gain. The cash proceeds from the sale of an investment are an Investing activity, however, the gain would have been included in the Income Statement. Since the gain was NOT from Operating activities, it must be deducted from Net Income ($10). (Note: under the direct method, this was ignored)

Cash	60	
Investment		50 (cost)
Gain on sale		10

3. **Changes in the balances of accrual related accounts are adjusted**. As we did for the direct method, all the changes in the balances must be accounted for. For example, A/R increased by $80. Therefore, the amount included for sales was $600, but the actual cash inflow was only $520, so we must take out the $80. Basically, if an **asset Increased, it is a deduction** on the indirect method, if a **Liability increased, such as A/P of $20, it is an addition** to the indirect method.

Note: Net cash provided/used by operating activities should be the **same** under either the Direct or the Indirect method. The Direct method is preferred by the FASB.

Supplementary Disclosures

- If direct method is used:
  - Schedule to **reconcile net income** to cash flow from operations
    - Identical to indirect method of preparing operating activities section.
  - Schedule of **noncash** investing and financing activities
    - Transactions having no effect on cash
      - Conversion of bonds to stock.
      - Purchase financed entirely by loan.
- If **indirect method** is used:
  - Cash payments for Interest and Income Taxes must be **Disclosed.**
  - Schedule of **noncash** investing and financing activities.
  - If cash or cash equivalents are restricted, the restricted amount is included in the total of cash and cash equivalents when reconciling the beginning and ending balances
  - If reported separately on the balance sheet, statement of cash flows required to identify amounts of cash, cash equivalents, and restricted cash or restricted cash equivalents, on the balance sheet as well as the line items on the balance sheet where they are located
  - The sums of the line items identified in the beginning and ending balance sheets should agree with the beginning and ending balances reported on the statement of cash flows
  - Disclosures may be in the footnotes or on the face of the statement of cash flows and may be in a narrative or a tabular form.
- **Cash flows per share** are *NOT Disclosed*

Cash to Accrual

Another topic regularly tested on the exam is the conversion of cash basis financial statements to the accrual basis. Many questions will provide the amount of cash paid for an expense, or received for a revenue item. The increases and decreases in related accrual accounts such as accounts

receivable, accounts payable, prepaid expenses, or accrued expenses, are also provided. The question will require the calculation of the appropriate accrual basis amount.

A similar approach should be used to solve these questions as is used for solving questions calling for items to be reported on a statement of cash flows under the direct method, referred to as the journal entry approach. In applying this approach:

- Debit or credit cash for the amount given
- Debit or credit the related accrual accounts for the increase or decrease
- The amount required to balance the entry will be the accrual basis amount for the revenue or expense item.

Assume that a company reported cash receipts from customers of $345,000. Accounts receivable had a beginning balance of $29,000 and an ending balance of $31,000. Sales can be calculated by adding the $31,000 ending accounts receivable to cash receipts of $345,000 and deducting $29,000, resulting in sales of $347,000.

- Revenues = Cash received + increase (or - decrease) in accounts receivable
- Revenues = $345,000 + $2,000 = $347,000

Cash Receipts (given)	345,000	
Increase in A/R	2,000	
Sales (plug)		347,000

The same methodology is applied when converting cash paid for merchandise into cost of goods sold. Cash paid for merchandise is increased by the ending accounts payable balance, representing goods purchased in the current period but not yet paid for, and reduced by the beginning balance to exclude payments made in the current period for goods purchased in previous periods. The result will be goods purchased during the period, but not cost of goods sold.

Purchases will be increased by beginning inventory, representing goods purchased in previous periods that may have been sold in the current period, and decreased by ending inventory, representing goods purchased in the current period or prior periods but that is not yet sold. The result will be cost of sales.

- Cash payments for merchandise + increase (or - decrease) in accounts payable = purchases
- Purchases - increase (or + decrease) in inventory = cost of goods sold

Cost of Goods Sold (plug)	X	
Inventory (Increase in Inventory)	X	
Cash paid (given)		X
A/P (Increase in A/P)		X